APPENDIX

FOMC PRESENTATION
E.M. Truman
February 4, 1980

Introduction

Mr. Chairman, we have prepared for the Committee a background presentation on "international financial trends." U.S. monetary policy decisions affect such trends and, to some extent, may be affected by them. With that in mind, and using the package of materials before you, Jeff Shafer and George Henry will review some of the economic and financial factors influencing exchange market developments and some of the international financial implications of the oil situation. When they have finished, I will offer a few concluding comments.

Mr. Shafer.

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FOMC PRESENTATION
Jeff Shafer
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The red line in the top panel of Chart 1 shows the weighted-average foreign exchange value of the dollar since 1973 -- the begininning of the floating exchange rate period. The black line shows the ratio of foreign to U.S. consumer prices.

From March 1973 to 1976 the trend of the dollar, although obscured by sizable fluctuations, appears to follow the rising path of foreign prices relative to U.S. prices. The decline of the dollar since then has been associated with a downward movement of prices abroad relative to prices here. But the slide of the dollar has been much steeper than the trend in relative prices. The bottom panel shows the resulting drop in one measure of the price-adjusted average value of the dollar-- or what is often referred to as the real exchange rate.

Chart 2 plots bilateral movements of the dollar against the currencies of Germany, Japan, Switzerland and the United Kingdom, together with the ratio of the price level in each of these economies to the U.S. price level. The chart indicates a general correspondence between price trends and exchange rate trends. Since March 1973, the dollar has depreciated against the currencies of the top three countries, where prices have risen more slowly than in the United States. It rose against the U.K. pound through 1976, in line with the more rapid rate of price increase in the United Kingdom. But since then, the dollar exchange rate against the pound has fallen below the trend of relative prices, as factors such as North Sea oil contributed to a strengthening of pound.

Relative price movements are clearly an important element in accounting for trends in the dollar. In 1980, the staff expects prices abroad to rise more slowly than U.S. prices, but probably by only one or two percent. Price increases in Germany and Switzerland, however, are expected to be substantially less than in the United States.

Several factors have operated since March 1973 to cause dollar exchange rates to deviate from the path of relative prices. Chart 3 provides a perspective on the relationship between interest rate developments and the exchange market performance of the dollar. The weighted-average exchange rate for the dollar is shown again in the top panel.

The middle panel shows the 90 day interest rate on U.S. CDs in red and a weighted-average of 3-month foreign interest rates in black. As can be seen from the Chart, U.S. and foreign interest rate movements have been broadly parallel. The red line in the bottom panel shows the movements in the differential between U.S. and average foreign interest rates that <u>have</u> occurred. For comparison, the black line presents the differential between the U.S. inflation rate and the average foreign inflation rate over the previous 12 months. Longer-term movements in the interest rate differential have tended to follow the inflation differential.

One episode in which short-run interest rate developments deviated from inflation developments and had a significant short-run impact on the dollar occurred from late 1974 to late 1975. During this period the drop in U.S. interest rates relative to foreign interest rates and the subsequent reversal were parallelled by a decline in the dollar and then a recovery. In contrast with this episode, the dollar remained firm in 1976 even though U.S. interest rates fell behind rising foreign interest rates while the inflation differential was stable. This pattern reflects the behavior of several foreign central banks which raised interest rates sharply to moderate depreciations of their currencies.

The three panels in Chart 4 repeat for the German mark and the dollar the same comparisons made in Chart 3. The bottom panel shows that from March 1973 through 1975 sizable fluctuations in relative interest rates corresponded reasonably well with short-run fluctuations in the mark-dollar exchange rate. But from late 1975 through late 1978 the interest differential and inflation differential between the two countries tracked rather closely. Over this period the dollar followed a weakening trend against the mark, but short-run fluctuations about this trend were small. Despite a narrowing of the differential between U.S. and German interest rates in 1979, with no reduction in the inflation differential, the dollar declined only moderately against the mark.

For the record, in 1980, we expect interest rates abroad to remain in their recent range on average, including in Germany.

Shifting demands for assets denominated in dollars, for reasons other than movements of relative price levels or rates of return, also influence dollar exchange rates. For example, it has been argued that the advent of floating exchange rates has provided an incentive for official holders of dollars to diversify into other currencies in order to reduce the variability in the value of their reserves. Chart 5 summarizes some evidence concerning diversification. The top panel shows the evolution of the composition of the foreign exchange reserves of a sample of 76 countries.

The chart suggests that since 1973 there has been no secular trend of diversification out of dollars. Rather, the share of sterling has declined markedly while the shares of marks and other currencies have risen. The dollar share of reserves rose from 1973 to 1976 and has declined moderately since 1977. It was still well above its 1973 low in September 1979. The decline in the dollar's share since 1977 is largely attributable to the effects of exchange rate changes on the valuation of reserves rather than to sales of dollars for other currencies or major shifts in the currency distribution of additions to reserves.

More recently there have been reports of some OPEC diversification; but we have no evidence that, aside from Iran, large shifts have occurred. Looking ahead, if the dollar weakens for other reasons, official diversification, or fear of it in the aftermath of the Iranian asset freeze, may add to the downward pressures on the dollar. But the evidence suggests that if other factors become favorable for the dollar, official reserve management might not be a negative factor and indeed might over time even have a positive effect.

The lower panel on the Chart shows the currency composition of Euro-currency liabilities. This Chart is presented to give a rough indication of trends in private as well as official use of the dollar. The movements of currency shares here roughly parallel those for official reserves.

Chart 6 presents data on official exchange market intervention in dollars by major countries. The middle panel shows net official dollar purchases by foreign central banks and by the United States. It indicates that the scale of net dollar intervention increased sharply in 1977 and has remained greater than in the earlier part of the floating rate period. Until 1978 most of the net intervention was undertaken by foreign central banks. In 1978 and 1979 the United States took a larger share.

In general, intervention purchases of dollars have occurred when the dollar has been weak, thereby moderating its decline, and sales have occurred when it has been strong, or to unwind previous intervention when the dollar has been at least stable. In 1974, however, net dollar sales occurred even though the dollar declined over the year. And in the second half of 1979 U.S. purchases of dollars to counter downward pressure in exchange markets were offset by the net official sales of foreign central banks. Intervention that runs counter to the trend of the dollar's value, or that is offsetting among countries, reflects the reserve and intervention currency roles of the dollar. Some of the differences in intervention by individual central banks can be seen in the bottom panel where net dollar purchases by Germany, Japan, and other countries are shown. Years in which intervention by the three have been in opposite directions have been common.

Assessment of the effects of intervention on exchange rates is difficult, since a judgment as to how much further a currency might have moved in the absence of intervention is required. Moreover, in most episodes of dramatic success, intervention has been initiated in conjunction with new monetary or other policy actions. The principal effect of intervention under such circumstances may be to underscore the importance authorities attach to the exchange rate in setting and executing their overall economic policies.

George Henry will continue our presentation.

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Complementing the factors that Mr. Shafer has reviewed, especially the influence of relative price levels, the behavior of the U.S. current-account position in 1977 and 1978 helps to explain the decline in the value of the dollar in those years. Perhaps the most important channel through which current-account developments affect exchange rates is by influencing expectations concerning rate adjustments that may be required to achieve sustainable external positions over time. How current-account developments affect expectations will depend on the market's view of the underlying factors at work. As can be seen from a comparison of the panels in Chart 7, the declining U.S. current-account position in 1976, attributed at the time to temporary cyclical factors, was associated with an appreciating dollar. The cyclical character of these developments was called into question by the further sharp decline in our balance in 1977 and substantial downward pressure on the dollar emerged.

Recently, the U.S. current account has improved notably. Substantial growth in net service receipts has contributed importantly to this favorable swing. As shown in the top panel of Chart 8, growing income on net investment abroad has recently been a dynamic factor. Net investment-income receipts now exceed $30 billion, of which approximately half is reinvested abroad.

Our trade position also has exhibited large shifts in recent years. The balance excluding agricultural exports and oil imports is shown in the second panel of the chart; it declined steadily and sharply from the recession-induced surplus of 1975 through the beginning of 1978. It has shown an equally dramatic improvement over the past two years and is now nearing surplus. As can be seen from the final two panels, this improvement has reflected substantial growth in the volume of our non-agricultural exports and stable non-oil imports -- both largely attributable to the earlier depreciation of the dollar.

Our projections suggest that the current account is not likely to be a bearish factor for the dollar at least after the first half of this year. These projections fold in the huge increases in our bill for imported oil (depicted in Chart 9) that have occurred and are expected to continue. Similar increases, of course, have affected every oil-importing country and they have affected as well the external position of OPEC.

As can be seen in Table 1, line 3, the initially huge OPEC current-account surplus in 1974 had virtually disappeared by 1978. The deficits of the non-oil developing countries, which peaked in 1975, had been worked down to more reasonable levels by 1977. The big oil-price increases of 1979 have taken us back to square one if not beyond; we project an OPEC surplus of $100 billion or more in 1980 and a very substantial widening in the deficits of non-oil developing countries. These prospects raise anew the so-called "recycling question," that is, the capacity of the international financial system to handle OPEC's surplus and to channel funds to countries in deficit, in particular to developing countries.

Chart 10 provides some historical perspective on this question. As can be seen in the top panel, official flows to non-oil developing countries increased rather rapidly during the period of large and rising deficits in 1974-75; since 1975 official flows have risen more modestly. The middle panel shows that banking flows also rose sharply in 1974 and 1975, and then leveled off. But they have expanded again recently. As indicated in the final panel, developing countries as a group added substantial amounts to their gross reserves in every year after 1975.

Table 2 provides some detail on the recent behavior of bank claims on non-oil developing countries. Debts to banks rose as a share of total debt of these countries from about 25 percent in December 1973 to almost 45 percent at the end of 1979. Initially in 1973, and for several years thereafter, U.S. banks held more than half the claims, but since 1976 U.S. bank credits have risen much more slowly than have those of foreign banks -- and the U.S. share of the total has consequently fallen substantially.

The upper panel of Chart 11 plots total claims of U.S. banks on non-oil developing countries. Growth of these claims slowed over the past four years as international lending became a significant part of total portfolios. As is shown in the bottom panel of the chart, claims relative to bank capital and assets have remained essentially unchanged for about two years -- after having risen sharply earlier. One factor in the slower recent pace of lending to developing countries by U.S. banks may have been the low spreads that have recently prevailed on syndicated Eurocurrency credits. Moreover, some U.S. banks may have reached levels of exposure to certain major borrowing countries beyond which they would not have felt comfortable. Such a situation does not imply a cessation of increases in U.S. banks' lending to developing countries -- particularly if spreads were to rise; it more likely suggests a continuation of the moderate pace of lending of recent years.

At first blush, growth in bank credit to non-oil developing countries no faster than that of recent years would appear to suggest a distinct financing problem, since the deficits of these countries, shown in the upper panel of the final chart, are expected to be substantially enlarged in 1980 and 1981. I noted earlier, however, that borrowing in recent years has exceeded these countries' immediate financing requirements -- in fact, by about $10 billion per year on average over the past four years. Simply eliminating reserve increases by non-oil developing countries would thus significantly reduce borrowing requirements.

Moreover, as can be seen in the middle panel, increases in IMF quotas and the establishment of special facilities have substantially increased the availability of Fund resources. Some net use of reserves by non-oil developing countries may be called for in the future and, given the relatively high level of their reserves, this would not in itself be cause for alarm.

On balance, the prospective stresses in international financial markets, generated in large part by sharply rising energy prices, appear to be basically manageable -- but there are some potentially serious risks. These include: (1) the possibility of further large oil disruptions; (2) the possibility that developing countries may fail to take prompt steps that would reduce their deficits over time and, consequently, that severe economic adjustment on the part of a number of those countries will ultimately be required in order for them to service their debts; or (3) the possibility that countries, developed as well as developing, will impose trade restrictions in an effort to ameliorate their own difficulties.

Ted Truman will now conclude our presentation.

E.M. Truman

Concluding Comments

One aspect of international developments that is of major concern to the Federal Reserve is the foreign exchange value of the dollar. For that reason, Mr. Shafer and Mr. Henry have reviewed the economic and financial factors that are commonly regarded as influencing the dollar's value.

No one factor should be regarded as dominating the determination of the dollar's foreign exchange value over all time periods. Nevertheless, over the longer run--measured in years--a central role must be assigned to monetary policy. But the long run often is not the focus of immediate concern. And it is much more difficult to sort out the direct influence of various factors in the short run--measured in months.

One way to summarize the short-run influences on the dollar is to think in terms of the demand for dollar-denominated assets. That demand can be viewed as being determined in the short run by two factors: the nominal interest-rate differential and the expected exchange-rate change. If U.S. interest rates decline relative to foreign interest rates, everything else being equal, the quantity of dollar-denominated assets demanded and, hence, the exchange value of the dollar would be expected to decline.

But everything else may not be equal. Specifically, the complex of factors that bear on the expected exchange-rate change may not remain constant. These include the other factors Jeff and George reviewed: relative inflation rates, diversification practices, intervention activity, and current account developments. In particular, the exchange rate is strongly influenced by what is expected to happen to economic variables and to policies affecting those variables. The market may react sharply based on its perception of changes in policies, especially those affecting inflation rates.

A broader area of Federal Reserve concern is the smooth functioning of the international financial system. As Mr. Henry has outlined, we believe that the overall situation with regard to current account surpluses and deficits, and their financing, in 1980 and 1981, is basically manageable. However, many countries face serious difficulties, and the capacity of developing countries to cope with their prospective, larger deficits without excessive reliance on new bank financing will depend to a considerable extent on whether the demand for their exports is reasonably well maintained.

Thus, there are risks, and they have increased significantly in recent months with the further rise in oil prices on top of an expected slowdown in global economic activity. These risks will be present even in a relatively stable international political environment, which may be an optimistic assumption. Disruptions in the international financial system would almost certainly spill over into exchange markets, although the implications for the foreign exchange value of the dollar might be either positive or negative. Perhaps more importantly, many such disruptions would have serious, adverse implications for inflation, for the health of the U.S. banking system, and for prospects for economic growth in the near and long term.

That concludes our presentation, Mr. Chairman.